have more fundamental challenges ahead as we work to live up to our charge to ensure that data filed by carriers are adequate, truthful and thorough.

I believe the Joint Conference should move next to assess broader issues that impact regulatory accounting and reporting reliability. I hope we can start by rigorously reviewing the scope of the authority granted to the Commission by Congress. In particular, I would like the Joint Conference to consider how use of the Commission's authority to inquire into the business management of carriers under Section 218 might have helped us to identify recent corporate governance problems ranging from capacity swaps to tactics to circumvent access charges. The Commission also has specific requirements that carriers must comply with concerning continuing property records. I hope we can take a hard look at how the Commission can undertake regular continuing property record audits to ensure that carriers maintain equipment in compliance with Commission rules and verify that property is recorded in proper accounts. Finally, I hope the Joint Conference can serve as a vehicle for jumpstarting discussion with other agencies at the state and federal level with interest in the soundness of regulatory accounting and reporting requirements. Such discussion could help inform the recommendations of the Joint Conference to the Commission.

I commend my state and federal colleagues on the Joint Conference for their extraordinary effort. I commend them for their commitment to thinking through the thorny issues of our accounts, subaccounts, separate affiliate rules and reporting requirements. This group tackled issues as complex as they come. They are devoted to ensuring we craft an accounting regime that will best serve the public interest. We all benefit from their contributions and hard work. I also wish to commend the leadership of our Chairman, FCC Commissioner Martin. Commissioner Martin has encouraged the Joint Conference to act expeditiously on the specific accounting rules before us and also to look more broadly at what needs to be done so that our accounting rules are up to the needs and the high standards of corporate governance that the American people have a right to expect in light of events over the past few years.

Form 477[83] data is not adequate. The FCC Form 477 does not include any interconnection revenue or expense data. While some data relates to local competition (e.g., number of UNE loops), none of the data is audited, calling the reliability of the data into question. The Form 477 does not collect comprehensive data on all interconnection activities (e g., the only UNE data collected on Form 477 is UNE loop data and there are many other types of UNEs offered) Accounting data is essential to understand the nature of the competition (e.g., is it healthy, is there resale activity and at what level). Form 477 data is confidential, resulting in delays for states in obtaining access to the data and making other state's data unobtainable. Further, given its confidentiality, it will be difficult for states to use the data in a hearing or publicly issued decisions.

As universal service funds expand in order to make implicit subsidies explicit in nature, information in this area is likely to increase in importance.[84] Revenue flow is highly CLEC to ILEC in nature. It is less likely that an ILEC will buy unbundled access to a CLEC's network or will resell a CLEC's services. Additionally, an ILEC is not likely to collocate in a CLEC's central office Interconnection accounts would assist states in assessing local competition and whether such competition is getting a foothold in their states. This data could prove useful to states in formulating policy. The addition of these accounts would clearly help the states and the FCC better understand the degree of local competition and enable regulators to take steps to address issues that may be relevant to the state of local competition.

The current USOA appears to support classification of interconnection expenses in Account 6540, Access Expense. Reciprocal compensation is an expense associated with local service, whereas access expenses are related to long distance service. A separate account or subaccount is needed for an ILEC's reciprocal compensation paid to other entities. As noted by NASUCA, in Ohio, the carrier that is the recipient of the greatest amount of federal high cost universal service support currently includes that amount in Account 5082, Switched Access Revenue. This account is allocated entirely to the interstate jurisdiction, despite the fact that the purpose of this support is to keep local rates low. This particular carrier's local rates are among the highest in the state.[85]

ILEC arguments concerning the availability of data are overstated. BellSouth states that interconnection revenues are identifiable within its accounting system and are routinely provided to state commissions in regulatory proceedings. The revenues are journalized to the revenue accounts corresponding to the services being sold but they can be identified through underlying accounting codes. BellSouth asserts that to record resale revenues in one account would require reprogramming of accounting systems and also require changes to Part 36[86] separations process and procedures. According to BellSouth, UNE and local reciprocal compensation revenues are currently recorded as miscellaneous revenue in Account 5200 and are separately identifiable.

[83] FCC Form 477 – Local Competition and Broadband Reporting.

[84] *Wisconsin Comments* at 12

[85] *NASUCA Comments* at 15

[86] 47 C F R Part 36.

however, it is not clear to me that the benefits of extending the affiliate transactions rules into this area outweigh the costs [3]

Despite these concerns, I believe it is extremely important that a forum be developed for notifying the Commission of accounting-related concerns and for identifying issues of concern to the states In this regard, the Joint Conference on Accounting has been extremely successful at facilitating state commission input into the Commission's decision-making process for accounting issues and for renewing and beginning to formalize a dialogue on the broader issues related to accounting

I support the Joint Conference recommendation for the Commission to initiate a Notice of Proposed Rulemaking seeking comment on the Joint Conference proposals. I look forward to continuing to work on these recommendations of the Joint Conference, and to receiving additional feedback from our state colleagues and others as we work to resolve these issues.

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[3] Similarly, I have some concerns about the recommendation to eliminate the central services organization exemption to the affiliate transactions rules, which the Commission adopted as part of the post-1996 Act rulemaking on accounting issues In the 1996 rulemaking, the Commission found that the central services organization exemption would benefit consumers by allowing incumbent LECs to take advantage of economies of scale and scope *See Accounting Safeguards Order* at para 148 (explaining the basis for the central services organization exemption) Based on the information available at this time, I question whether it is necessary to eliminate the exemption for central services organizations

would promote symmetry with the current treatment of transactions involving services, effectively eliminating any incentive for companies to turn "assets" into "services."[91]

This change did not garner any opposition from interested parties in response to the *Joint Conference Public Notice*.[92] In support, ILECs contend the change is inconsequential.[93] BellSouth noted that, from January to October 2002, asset transfers that fell within the parameters of the rule as revised totaled $1.3 million. That total equates to approximately 4% of all asset transfers, and 0 005% of BellSouth's net fixed assets.[94]

The Wisconsin Commission specifically supports the change as set forth in the *Phase II Report and Order*, agreeing that the treatment of services and assets should be symmetrical for such small transactions.[95]

B Establishment Of Floor And Ceiling For Recording Transactions

**Issue:** Should the Commission reverse its decision to allow ILEC discretion in valuing affiliate transactions as long as the valuation complies with a prescribed floor or ceiling?

**Recommendation:** Yes. The Joint Conference recommends that the FCC reverse its decision to permit ILECs to have such discretion in valuing affiliate transactions.

In its *Phase II Report and Order*, the FCC revised its affiliate transaction rules to permit carriers to use the higher or lower of cost or market valuation as either a floor or ceiling when valuing transactions.[96] Prior to this change, where a carrier was the recipient of an asset or service, that asset or service was required to be recorded on the carrier's books at the lower of cost[97] or fair market value (FMV). If the carrier provided the asset or service, the carrier valued the transferred asset or service at the higher of cost (FDC or NBC) or market value. The change approved in the *Phase II Report and Order* allows carriers to assign whatever value they deem appropriate for a transaction, as long as the value falls within the parameters of the adopted floor and ceiling. The effect of this rule change is to allow carriers greater flexibility in valuing these transactions.[98]

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[91] *Id*

[92] *See, Joint Conference Public Notice*

[93] *See, BellSouth Comments* at pp 13-14, *Verizon Comments*, Appendix at p 1

[94] *BellSouth Comments* at 13.

[95] *Wisconsin Comments* at 12

[96] *Phase II Report and Order*, paras 91-92.

[97] Generally, "cost" is the fully distributed cost (FDC) when valuing services and the net book cost (NBC) when valuing assets

[98] The FCC offered the following example· If an ILEC were buying an asset with a NBC of $750,000, and a FMV of $1,000,000, the rules prior to the *Phase II Order* required the ILEC to record the asset at $750,000, which is the lower of cost or market The change adopted by the FCC permits the carrier to record the asset, purchased from one of its non-regulated affiliates, at any valuation up to the ceiling of $750,000 (the lower of NBC and FMV). Arguably, the ILEC could choose to record the transaction at a value of $0 *See, Phase II Report and Order*, n. 172

Corporation Commission

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Prevailing price valuation permits ILECs to value sales of assets and services without establishing the cost or fair market value, but rather based solely on the price of that asset or service when sold to the general public (*i.e*, a non-affiliated third party). Adopting a USTA proposal, the *Phase II Report and Order* reduced the threshold to qualify for prevailing price valuation from 50 percent to 25 percent of sales of a particular asset or service to third parties. The FCC explained that the purpose of the threshold is to ensure that sufficient transactions take place with the general public, as opposed to merely with the affiliate, to "produce a reasonable surrogate of a true market price."[103] The FCC concluded that it would unlikely be "a sustainable strategy for a firm significantly to under-price transactions with 25 percent of its customers in order to be able to record transactions at this price with an affiliate."[104]

The *Phase II Report and Order* reflects the assumption that there are no situations in which an ILEC would under-price 25% of the sales of a good or service to third parties in order to gain the benefit of below cost pricing to affiliates for the remaining 75% of sales of that good or service. However, it is not uncommon for parties in commercial relationships to exchange mutual concessions in the sales of goods and services

For example, ILECs frequently enter into partnership agreements and other contractual relationships with nonaffiliated third parties (*e g*, SBC partners with Yahoo for Internet access service) in which it could be advantageous for the ILEC to provide an asset or service to the third party at a favorable, below cost price The ILEC may receive a similar concession on a product or service provided by the third party. In such a situation, an ILEC could strategically under-price a relatively small amount of a particular service or asset to gain an offsetting concession from the third party, and at the same time confer on its affiliate a competitive advantage. By under-pricing services or assets, the ILEC would be absorbing some of the cost and thereby lowering the affiliate's overall cost structure, to the overall benefit of the ILEC's holding company.

Additionally, ILECs could use this new discretion to offset higher-than-desired earnings at the regulated entity. This would be an advantageous strategy whenever an ILEC believes it would benefit from making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement.

D. Modification Of The Centralized Services Exception To The Estimated Fair Market Value Rule

**Issue**: Should the FCC eliminate the centralized services exemption to the affiliate transactions rules?

[103] *Phase II Report and Order* at para 94

[104] *Id.*

obligations by transferring a network element to a section 272 affiliate, noting that the section 272 affiliate would be deemed an ILEC under section 251(h) as a successor or assign of the BOC. However, this argument seems to confirm the wisdom of the FCC's action in using the broad, more general definition

Approval of the limited definition of an ILEC, as proposed by SBC, would provide incumbent LECs with an inappropriate opportunity to avoid the statutory and regulatory obligations of ILECs by transferring discrete service to a success or assign, and should be denied.

The Commission's 1996 decision creating the exception should be revisited in light of the concerns raised by the accounting scandals of recent years. The exception confers on the carrier and its holding company the opportunity to have the carrier pay in excess of market prices for services obtained from an affiliate. The corporate family is not harmed by such overpayments as the holding company is unaffected by intra-holding company transfers. However, the regulated carrier may find it advantageous to show artificially high costs and, as a result, depressed earnings One of the goals of the Joint Conference is to limit opportunities for carriers to manipulate their financial statements. Eliminating the exception will further this goal.

In addition, regulated carriers that record excessive costs for services from an affiliate can use those costs to justify excessive wholesale or retail rates. Affiliate transaction rules should not permit carriers to use transactions with affiliates to justify artificially high costs that are then passed on to competitors or end users buying services for which the ILEC retains market power The *Accounting Safeguards Order* does not explain why a carrier with market power would not have the opportunity to take advantage of the exception to justify unduly high wholesale or retail prices.

E Exemption Of Nonregulated To Nonregulated Transactions From The Affiliate Transactions Rules

**Issue**: Should the FCC continue to defer action on whether nonregulated to nonregulated transactions should be exempted from the affiliate transactions rules?

**Recommendation:** Yes. The Joint Conference recommends that the FCC maintain the current reporting requirements for nonregulated to nonregulated affiliate transactions and take no additional action at this time.

Under current rules, when a carrier sells an asset used exclusively in its nonregulated operations to its nonregulated affiliate, the asset must be valued according to the affiliate transactions rules. In the *Phase II Notice*, the FCC asked whether nonregulated to nonregulated transactions should continue to be exempt from the affiliate transactions rules. The FCC deferred action on the proposal, "as it raises broader issues that should be considered in a more comprehensive fashion."[110]

With the increased re-integration into BOCs of affiliates that have previously been separate affiliates (e.g., long distance, advanced services), retention of this rule is necessary to prevent manipulation of costs and revenues associated with affiliate transactions. Such manipulation could be used to distort the overall financial results of regulated carriers, a concern that gave rise to this Joint Conference.

[110] *Phase II Report and Order* at para 100

to the broader universe of LECs would produce any measurable benefit.[146] While requiring a larger universe of carriers to report fiber and DSL deployment would have significant benefits, especially in an environment in which the ILECs are seeking major regulatory reforms based on claims about their fiber and DSL deployment incentives and activities, AT&T argues that requiring this information to be produced through Form 477 would impose unnecessary costs upon competitive LECs.[147]

In summary, the carriers argue that the fiber and xDSL deployment data should be reported in Form 477 because it is confidential and proprietary information and will avoid duplicative and potentially inconsistent reporting requirements. The reporting of data in ARMIS reports does not preclude carriers from seeking confidential treatment of the data. On the other hand, the reporting of data in Form 477 does not automatically guarantee that the data will be held confidential Whether reported in ARMIS Report 43-07 or Form 477, carriers will be required to show that fiber and xDSL deployment data fall within the FCC's confidentiality rules For this reason, the Commission should deny the *Joint Petition for Reconsideration* and require the reporting of broadband infrastructure data in ARMIS Report 43-07 as set forth in the *Phase II Report and Order* Nonetheless, the reporting of broadband infrastructure data should continue to be evaluated as to whether the data collection should be expanded to a larger universe of carriers.

C Dominant Vs. Non-Dominant Carriers

**Issue** Should the FCC agree with the "Dominant vs Non-Dominant" argument of SBC in its Petition for Reconsideration?

**Recommendation**: No. SBC proposed that only dominant ILECs be subject to the Commission's accounting regulation. Approval of the limited definition of an ILEC, as proposed by SBC, would provide incumbent LECs with an inappropriate opportunity to avoid the statutory and regulatory obligations of ILECs by transferring a discrete service to a successor or assignee, and should be denied.

In its separate Petition for Reconsideration, SBC Communications Inc. asked the FCC to clarify that the amendment adopted to rule 32.11 of its accounting and reporting rules apply only to ILECs, as narrowly defined in 47 U.S.C. sections 251(h)(1)(A) or 251(h)(2)(B)(i), rather than to all ILECS as generally defined in section 251(h).[148] SBC argues that the fact that a carrier meets the general definition in section 251(h) does not consider whether the carrier is "dominant" in the markets in which it operates.[149]

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[146] *Id*

[147] *Id* at 3

[148] *See, SBC Reconsideration*

[149] *Id* at 2

**Recommendation**: Yes. Following sunset of the structural separation requirements of section 272, the Joint Conference recommends that the BOC be required to maintain separate books of account for the provision of interexchange service and maintain an affiliate that provides in-region interexchange service that is subject not only to accounting review but also to certain safeguards.

The purpose of the separate affiliate and nondiscrimination requirements in section 272 is to lessen the ability of a BOC to discriminate and/or misallocate costs to the advantage of its own operations, and to make it easier to detect any such behavior. Section 272 (a) of the Act requires BOCs to provide in-region, interLATA telecommunications services through separate corporate affiliates, subject to certain safeguards.[112] Section 272 (b) requires that the separate affiliates maintain separate books of account and have separate officers and directors and that all transactions between the section 272 affiliate and the BOC be on an arm's length basis, pursuant to the Commission's affiliate transaction rules.[113] Sections 272 (c) and (e) impose nondiscrimination safeguards on the BOC and require that all transactions with the affiliate be accounted in accordance with the accounting rules designated or approved by the Commission.[114] Section 272 (d) requires the BOC to obtain and pay for a biennial joint federal/state audit after section 271 approval to determine compliance with the structural and transactional requirements of section 272 [115] Section 272(f)(1) provides that the provisions of the section, except for section 272(e), expire three years after a BOC or any BOC affiliate is authorized under section 271 to provide in-region, interLATA services, "unless the Commission extends such 3-year period by rule or order."[116]

In the *Accounting Safeguards Order* and the *Non-Accounting Safeguards Order*, the Commission adopted rules to implement the statutory requirements of section 272.[117] In the *Non-Accounting Safeguards Order*, the Commission concluded that as long as the BOCs retain market power in the provision of local exchange and exchange access services within their service areas, they have an incentive and ability to discriminate against their long distance competitors, and engage in other anti-competitive conduct. The Commission found the BOCs to be dominant carriers with an incentive to discriminate in providing services and facilities that their interexchange competitors need to compete in the interLATA services markets.[118]

[112] 47 U S C § 272(a)(2)

[113] 47 C F.R § 32.27 Under the affiliate transaction rules, transactions are to be valued at publicly available rates - specifically, a tariffed rate, a rate in a publicly filed agreement or statement of generally available terms, or a qualifying prevailing price valuation - if possible If there is no such publicly available rate, transfers from the BOC to the affiliate are booked at fair market value or net book cost, whichever is higher Transfers from the affiliate to the BOC are recorded at fair market value or net book cost, whichever is lower. The BOC may use any reasonable method to determine fair market value, an independent appraisal is not required

[114] 47 C F.R § 32.27

[115] 47 U S C § 272 (d). *Accounting Safeguards Order* at paras 184-204.

[116] 47 U S C § 272(f)(1)

[117] *See, Accounting Safeguards Order* and *Non-Accounting Safeguards Order.*

[118] *Non-Accounting Safeguards Order* at para 85

The stated rationale for the change appears to be that the FCC "conclude[d] that this information would be more useful for policymakers and interested parties if it were narrowed to local loop facilities connecting customers to their service offices. Therefore, we now change the title to "Loop Sheath Kilometers" and limit the collection of data to local loop facilities."

B Broadband Infrastructure Reporting

**Issue**. Should the FCC reconsider its Phase II decision regarding broadband infrastructure reporting?

**Recommendation**. No. The Joint Conference recommends the FCC deny the *Joint Petition for Reconsideration* regarding the reporting of broadband infrastructure data in ARMIS Report 43-07 Notwithstanding this, the reporting of broadband infrastructure data should continue to be evaluated as to whether the data collection should be expanded to a larger universe of carriers.

ARMIS is an automated reporting system developed by the FCC to collect financial, operating, service quality, and network infrastructure information that ILECs are required to collect under FCC rules. Specifically, ARMIS Report 43-07 (Infrastructure Report) collects information about the physical and operating characteristics of the ILECs.[135] ARMIS Report 43-07 collects data about the carrier's switching and transmission equipment, call set up time, and cost of total plant in service. This report is filed on a study area and holding company level. The report captures trends in telephone industry infrastructure development under price cap regulation. Policymakers at the federal and state levels use this information, which is critical data not available through other public sources.

In the *Phase II Notice*, the FCC sought comment on adding information on hybrid fiber-copper loop interface locations, number of customers served from these interface locations, xDSL customer terminations associated with hybrid fiber-copper loops, and xDSL customer terminations associated with non-hybrid loops to the ARMIS Report 43-07.[136] The *Phase II Report and Order* concluded that the addition of this information to ARMIS would help to "satisfy an immediate and pressing need to assess the penetration of fiber in the local loop and gauge the development of broadband infrastructure."[137] The FCC recognized that hybrid architectures will likely become increasingly important in providing broadband services and are directly relevant to current criticisms by new entrants that the new architectures are systematically diminishing their ability to provide competing DSL service to end-user retail customers. The FCC therefore found that there is a present federal regulatory need, at least for the near term, to collect such data to evaluate the effects of public policy decisions and to consider whether more market-oriented approaches are appropriate.[138] However, comment was

[135] The ARMIS Report 43-07 – Infrastructure Report, is required for 30 mandatory price cap incumbent ILECs.

[136] *Phase II Notice* at para. 74

[137] *See, Phase II Report and Order* and *Phase II Further Notice*

[138] *Phase II Report and Order* at para 175, nn. 332-335

The section 272 safeguards are designed to reveal and discourage BOC subsidization of their long-distance affiliates by recovering the affiliates' costs from local and exchange access customers The 272 structural affiliate requirement is a mechanism to control cost shifting in the form of misallocation of joint and common costs by forbidding joint operations and joint marketing. The Commission noted in the *272 Sunset Notice* that maintaining a separate affiliate creates a more transparent record of transactions between the BOC and its affiliate, thereby facilitating detection of discriminatory behavior.[127] In the absence of those safeguards, the possibility of cross-subsidization is heightened [128] The Commission found in the *Accounting Safeguards Order* that as long as the BOC, through its control of bottleneck facilities, has dominance over local exchange and exchange access service, there is an incentive for cross-subsidization [129] Moreover, the Commission made clear in the *LEC Classification Order* that its existing non-dominant treatment of the BOC long-distance affiliates was "predicated" on the existence of section 272.[130]

In the *Accounting Safeguards Order*, the Commission relied extensively on the existence of the structural safeguards, audit requirements and affiliate transaction requirements of section 272 to support its finding that there are sufficient safeguards to prevent the BOCs from eliminating competing IXCs by engaging in improper cost misallocation.[131] When the 272 structural affiliate requirements and nondiscriminatory safeguards are eliminated, the separate structural requirement will dissolve. The integration of the BOC's local operations with its interLATA activities will increase the risks of cost shifting. For example, an ILEC could use profits from vertical features such as call waiting, call forwarding, and caller ID to subsidize low long-distance rates. Without safeguards, the BOC could subsidize its more competitive long distance services by over-pricing local services.

In the *Competitive Carrier Fifth Report and Order*, the Commission concluded that independent ILEC provision of interstate, domestic, interexchange services is subject to non-dominant treatment if such services are offered through an affiliate that meets certain requirements [132] While the separation requirements do not require actual structural separation, the affiliate must: (1) maintain separate books of account; (2) not jointly own transmission or switching facilities with the exchange telephone company, and (3) obtain any exchange telephone company services at tariffed rates and conditions.[133] Except for the ban on joint

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Docket No 02-112 and CC Docket No 00-175, Further Notice of Proposed Rulemaking, (rel May 19, 2003) (*Further 272 Sunset Notice)*

[127] *272 Sunset Notice* at para. 22

[128] *In the Matter of Extension of Section 272 Obligations of Southwestern Bell Telephone Co In the State of Texas*, WC Docket No 02-112, Petition of AT&T Corp at 8-9

[129] *Accounting Safeguards Order* at para 14

[130] *LEC Classification Order* at para 82

[131] *Accounting Safeguards Order* at paras 59-60

[132] *Competitive Carrier Fifth Report and Order* at para. 9

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[138] *Phase II Report and Order* at para 175, nn 332-335

**Recommendation**. Yes. Following sunset of the structural separation requirements of section 272, the Joint Conference recommends that the BOC be required to maintain separate books of account for the provision of interexchange service and maintain an affiliate that provides in-region interexchange service that is subject not only to accounting review but also to certain safeguards

The purpose of the separate affiliate and nondiscrimination requirements in section 272 is to lessen the ability of a BOC to discriminate and/or misallocate costs to the advantage of its own operations, and to make it easier to detect any such behavior. Section 272 (a) of the Act requires BOCs to provide in-region, interLATA telecommunications services through separate corporate affiliates, subject to certain safeguards [112] Section 272 (b) requires that the separate affiliates maintain separate books of account and have separate officers and directors and that all transactions between the section 272 affiliate and the BOC be on an arm's length basis, pursuant to the Commission's affiliate transaction rules.[113] Sections 272 (c) and (e) impose nondiscrimination safeguards on the BOC and require that all transactions with the affiliate be accounted in accordance with the accounting rules designated or approved by the Commission.[114] Section 272 (d) requires the BOC to obtain and pay for a biennial joint federal/state audit after section 271 approval to determine compliance with the structural and transactional requirements of section 272.[115] Section 272(f)(1) provides that the provisions of the section, except for section 272(e), expire three years after a BOC or any BOC affiliate is authorized under section 271 to provide in-region, interLATA services, "unless the Commission extends such 3-year period by rule or order "[116]

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[114] 47 C.F.R § 32 27

[115] 47 U S C § 272 (d). *Accounting Safeguards Order* at paras. 184-204.

[116] 47 U S.C. § 272(f)(1).

[117] *See, Accounting Safeguards Order* and *Non-Accounting Safeguards Order*

[118] *Non-Accounting Safeguards Order* at para 85

to the broader universe of LECs would produce any measurable benefit.[146] While requiring a larger universe of carriers to report fiber and DSL deployment would have significant benefits, especially in an environment in which the ILECs are seeking major regulatory reforms based on claims about their fiber and DSL deployment incentives and activities, AT&T argues that requiring this information to be produced through Form 477 would impose unnecessary costs upon competitive LECs.[147]

In summary, the carriers argue that the fiber and xDSL deployment data should be reported in Form 477 because it is confidential and proprietary information and will avoid duplicative and potentially inconsistent reporting requirements. The reporting of data in ARMIS reports does not preclude carriers from seeking confidential treatment of the data. On the other hand, the reporting of data in Form 477 does not automatically guarantee that the data will be held confidential. Whether reported in ARMIS Report 43-07 or Form 477, carriers will be required to show that fiber and xDSL deployment data fall within the FCC's confidentiality rules. For this reason, the Commission should deny the *Joint Petition for Reconsideration* and require the reporting of broadband infrastructure data in ARMIS Report 43-07 as set forth in the *Phase II Report and Order* Nonetheless, the reporting of broadband infrastructure data should continue to be evaluated as to whether the data collection should be expanded to a larger universe of carriers

C. Dominant Vs. Non-Dominant Carriers

**Issue** Should the FCC agree with the "Dominant vs. Non-Dominant" argument of SBC in its Petition for Reconsideration?

**Recommendation**: No. SBC proposed that only dominant ILECs be subject to the Commission's accounting regulation. Approval of the limited definition of an ILEC, as proposed by SBC, would provide incumbent LECs with an inappropriate opportunity to avoid the statutory and regulatory obligations of ILECs by transferring a discrete service to a successor or assignee, and should be denied.

In its separate Petition for Reconsideration, SBC Communications Inc. asked the FCC to clarify that the amendment adopted to rule 32.11 of its accounting and reporting rules apply only to ILECs, as narrowly defined in 47 U.S.C. sections 251(h)(1)(A) or 251(h)(2)(B)(i), rather than to all ILECS as generally defined in section 251(h).[148] SBC argues that the fact that a carrier meets the general definition in section 251(h) does not consider whether the carrier is "dominant" in the markets in which it operates.[149]

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146 *Id*

147 *Id* at 3

148 *See, SBC Reconsideration*

149 *Id* at 2

The Commission's 1996 decision creating the exception should be revisited in light of the concerns raised by the accounting scandals of recent years. The exception confers on the carrier and its holding company the opportunity to have the carrier pay in excess of market prices for services obtained from an affiliate. The corporate family is not harmed by such overpayments as the holding company is unaffected by intra-holding company transfers. However, the regulated carrier may find it advantageous to show artificially high costs and, as a result, depressed earnings. One of the goals of the Joint Conference is to limit opportunities for carriers to manipulate their financial statements. Eliminating the exception will further this goal

In addition, regulated carriers that record excessive costs for services from an affiliate can use those costs to justify excessive wholesale or retail rates. Affiliate transaction rules should not permit carriers to use transactions with affiliates to justify artificially high costs that are then passed on to competitors or end users buying services for which the ILEC retains market power. The *Accounting Safeguards Order* does not explain why a carrier with market power would not have the opportunity to take advantage of the exception to justify unduly high wholesale or retail prices

### E Exemption Of Nonregulated To Nonregulated Transactions From The Affiliate Transactions Rules

**Issue**: Should the FCC continue to defer action on whether nonregulated to nonregulated transactions should be exempted from the affiliate transactions rules?

**Recommendation:** Yes. The Joint Conference recommends that the FCC maintain the current reporting requirements for nonregulated to nonregulated affiliate transactions and take no additional action at this time

Under current rules, when a carrier sells an asset used exclusively in its nonregulated operations to its nonregulated affiliate, the asset must be valued according to the affiliate transactions rules. In the *Phase II Notice*, the FCC asked whether nonregulated to nonregulated transactions should continue to be exempt from the affiliate transactions rules. The FCC deferred action on the proposal, "as it raises broader issues that should be considered in a more comprehensive fashion."[110]

With the increased re-integration into BOCs of affiliates that have previously been separate affiliates (e.g., long distance, advanced services), retention of this rule is necessary to prevent manipulation of costs and revenues associated with affiliate transactions. Such manipulation could be used to distort the overall financial results of regulated carriers, a concern that gave rise to this Joint Conference.

[110] *Phase II Report and Order* at para 100

obligations by transferring a network element to a section 272 affiliate, noting that the section 272 affiliate would be deemed an ILEC under section 251(h) as a successor or assign of the BOC. However, this argument seems to confirm the wisdom of the FCC's action in using the broad, more general definition

Approval of the limited definition of an ILEC, as proposed by SBC, would provide incumbent LECs with an inappropriate opportunity to avoid the statutory and regulatory obligations of ILECs by transferring discrete service to a success or assign, and should be denied.

Prevailing price valuation permits ILECs to value sales of assets and services without establishing the cost or fair market value, but rather based solely on the price of that asset or service when sold to the general public (*i.e*., a non-affiliated third party). Adopting a USTA proposal, the *Phase II Report and Order* reduced the threshold to qualify for prevailing price valuation from 50 percent to 25 percent of sales of a particular asset or service to third parties. The FCC explained that the purpose of the threshold is to ensure that sufficient transactions take place with the general public, as opposed to merely with the affiliate, to "produce a reasonable surrogate of a true market price."[103] The FCC concluded that it would unlikely be "a sustainable strategy for a firm significantly to under-price transactions with 25 percent of its customers in order to be able to record transactions at this price with an affiliate."[104]

The *Phase II Report and Order* reflects the assumption that there are no situations in which an ILEC would under-price 25% of the sales of a good or service to third parties in order to gain the benefit of below cost pricing to affiliates for the remaining 75% of sales of that good or service. However, it is not uncommon for parties in commercial relationships to exchange mutual concessions in the sales of goods and services

For example, ILECs frequently enter into partnership agreements and other contractual relationships with nonaffiliated third parties (*e.g.*, SBC partners with Yahoo for Internet access service) in which it could be advantageous for the ILEC to provide an asset or service to the third party at a favorable, below cost price. The ILEC may receive a similar concession on a product or service provided by the third party. In such a situation, an ILEC could strategically under-price a relatively small amount of a particular service or asset to gain an offsetting concession from the third party, and at the same time confer on its affiliate a competitive advantage. By under-pricing services or assets, the ILEC would be absorbing some of the cost and thereby lowering the affiliate's overall cost structure, to the overall benefit of the ILEC's holding company.

Additionally, ILECs could use this new discretion to offset higher-than-desired earnings at the regulated entity. This would be an advantageous strategy whenever an ILEC believes it would benefit from making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement

### D. Modification Of The Centralized Services Exception To The Estimated Fair Market Value Rule

**Issue**: Should the FCC eliminate the centralized services exemption to the affiliate transactions rules?

[103] *Phase II Report and Order* at para 94

[104] *Id*

Corporation Commission

Dianna Hathhorn, Accountant, Financial Analysis Division, Illinois Commerce Commission

Cayce Hinton, Assistant to Commissioner Deason, Florida Public Service Commission

Rich Kania, Director of Finance, Maine Public Utilities Commission

Pat Lee, Sr Analyst, PSC, Florida Public Service Commission

Tom Long, Advisor to Commissioner Lynch, California Public Utilities Commission

ChristiAne Mason, Assistant Director, Telecommunications Division, New Hampshire Public Utility Commission

Joe Wiedman, Legal Intern, California Public Utilities Commission would promote symmetry with the current treatment of transactions involving services, effectively eliminating any incentive for companies to turn "assets" into "services."[91]

This change did not garner any opposition from interested parties in response to the *Joint Conference Public Notice*.[92] In support, ILECs contend the change is inconsequential.[93] BellSouth noted that, from January to October 2002, asset transfers that fell within the parameters of the rule as revised totaled $1 3 million. That total equates to approximately 4% of all asset transfers, and 0.005% of BellSouth's net fixed assets.[94]

The Wisconsin Commission specifically supports the change as set forth in the *Phase II Report and Order*, agreeing that the treatment of services and assets should be symmetrical for such small transactions.[95]

B Establishment Of Floor And Ceiling For Recording Transactions

**Issue:** Should the Commission reverse its decision to allow ILEC discretion in valuing affiliate transactions as long as the valuation complies with a prescribed floor or ceiling?

**Recommendation:** Yes. The Joint Conference recommends that the FCC reverse its decision to permit ILECs to have such discretion in valuing affiliate transactions.

In its *Phase II Report and Order*, the FCC revised its affiliate transaction rules to permit carriers to use the higher or lower of cost or market valuation as either a floor or ceiling when valuing transactions [96] Prior to this change, where a carrier was the recipient of an asset or service, that asset or service was required to be recorded on the carrier's books at the lower of cost[97] or fair market value (FMV) If the carrier provided the asset or service, the carrier valued the transferred asset or service at the higher of cost (FDC or NBC) or market value. The change approved in the *Phase II Report and Order* allows carriers to assign whatever value they deem appropriate for a transaction, as long as the value falls within the parameters of the adopted floor and ceiling The effect of this rule change is to allow carriers greater flexibility in valuing these transactions.[98]

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91 *Id*

92 *See, Joint Conference Public Notice*

93 *See, BellSouth Comments* at pp 13-14, *Verizon Comments*, Appendix at p. 1

94 *BellSouth Comments* at 13

95 *Wisconsin Comments* at 12.

96 *Phase II Report and Order*, paras 91-92

97 Generally, "cost" is the fully distributed cost (FDC) when valuing services and the net book cost (NBC) when valuing assets

98 The FCC offered the following example If an ILEC were buying an asset with a NBC of $750,000, and a FMV of $1,000,000, the rules prior to the *Phase II Order* required the ILEC to record the asset at $750,000, which is the lower of cost or market The change adopted by the FCC permits the carrier to record the asset, purchased from one of its non-regulated affiliates, at any valuation up to the ceiling of $750,000 (the lower of NBC and FMV) Arguably, the ILEC could choose to record the transaction at a value of $0 *See, Phase II Report and Order*, n. 172

however, it is not clear to me that the benefits of extending the affiliate transactions rules into this area outweigh the costs [3]

Despite these concerns, I believe it is extremely important that a forum be developed for notifying the Commission of accounting-related concerns and for identifying issues of concern to the states In this regard, the Joint Conference on Accounting has been extremely successful at facilitating state commission input into the Commission's decision-making process for accounting issues and for renewing and beginning to formalize a dialogue on the broader issues related to accounting

I support the Joint Conference recommendation for the Commission to initiate a Notice of Proposed Rulemaking seeking comment on the Joint Conference proposals. I look forward to continuing to work on these recommendations of the Joint Conference, and to receiving additional feedback from our state colleagues and others as we work to resolve these issues

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[3] Similarly, I have some concerns about the recommendation to eliminate the central services organization exemption to the affiliate transactions rules, which the Commission adopted as part of the post-1996 Act rulemaking on accounting issues In the 1996 rulemaking, the Commission found that the central services organization exemption would benefit consumers by allowing incumbent LECs to take advantage of economies of scale and scope *See Accounting Safeguards Order* at para 148 (explaining the basis for the central services organization exemption) Based on the information available at this time, I question whether it is necessary to eliminate the exemption for central services organizations

Form 477[83] data is not adequate. The FCC Form 477 does not include any interconnection revenue or expense data. While some data relates to local competition (e.g., number of UNE loops), none of the data is audited, calling the reliability of the data into question. The Form 477 does not collect comprehensive data on all interconnection activities (e.g , the only UNE data collected on Form 477 is UNE loop data and there are many other types of UNEs offered). Accounting data is essential to understand the nature of the competition (e.g., is it healthy, is there resale activity and at what level). Form 477 data is confidential, resulting in delays for states in obtaining access to the data and making other state's data unobtainable. Further, given its confidentiality, it will be difficult for states to use the data in a hearing or publicly issued decisions

As universal service funds expand in order to make implicit subsidies explicit in nature, information in this area is likely to increase in importance.[84] Revenue flow is highly CLEC to ILEC in nature. It is less likely that an ILEC will buy unbundled access to a CLEC's network or will resell a CLEC's services. Additionally, an ILEC is not likely to collocate in a CLEC's central office Interconnection accounts would assist states in assessing local competition and whether such competition is getting a foothold in their states. This data could prove useful to states in formulating policy. The addition of these accounts would clearly help the states and the FCC better understand the degree of local competition and enable regulators to take steps to address issues that may be relevant to the state of local competition.

The current USOA appears to support classification of interconnection expenses in Account 6540, Access Expense. Reciprocal compensation is an expense associated with local service, whereas access expenses are related to long distance service. A separate account or subaccount is needed for an ILEC's reciprocal compensation paid to other entities. As noted by NASUCA, in Ohio, the carrier that is the recipient of the greatest amount of federal high cost universal service support currently includes that amount in Account 5082, Switched Access Revenue. This account is allocated entirely to the interstate jurisdiction, despite the fact that the purpose of this support is to keep local rates low. This particular carrier's local rates are among the highest in the state.[85]

ILEC arguments concerning the availability of data are overstated. BellSouth states that interconnection revenues are identifiable within its accounting system and are routinely provided to state commissions in regulatory proceedings The revenues are journalized to the revenue accounts corresponding to the services being sold but they can be identified through underlying accounting codes. BellSouth asserts that to record resale revenues in one account would require reprogramming of accounting systems and also require changes to Part 36[86] separations process and procedures. According to BellSouth, UNE and local reciprocal compensation revenues are currently recorded as miscellaneous revenue in Account 5200 and are separately identifiable.

[83] FCC Form 477 – Local Competition and Broadband Reporting.

[84] *Wisconsin Comments* at 12

[85] *NASUCA Comments* at 15

[86] 47 C F.R Part 36

have more fundamental challenges ahead as we work to live up to our charge to ensure that data filed by carriers are adequate, truthful and thorough.

I believe the Joint Conference should move next to assess broader issues that impact regulatory accounting and reporting reliability I hope we can start by rigorously reviewing the scope of the authority granted to the Commission by Congress In particular, I would like the Joint Conference to consider how use of the Commission's authority to inquire into the business management of carriers under Section 218 might have helped us to identify recent corporate governance problems ranging from capacity swaps to tactics to circumvent access charges. The Commission also has specific requirements that carriers must comply with concerning continuing property records I hope we can take a hard look at how the Commission can undertake regular continuing property record audits to ensure that carriers maintain equipment in compliance with Commission rules and verify that property is recorded in proper accounts Finally, I hope the Joint Conference can serve as a vehicle for jumpstarting discussion with other agencies at the state and federal level with interest in the soundness of regulatory accounting and reporting requirements Such discussion could help inform the recommendations of the Joint Conference to the Commission.

I commend my state and federal colleagues on the Joint Conference for their extraordinary effort I commend them for their commitment to thinking through the thorny issues of our accounts, subaccounts, separate affiliate rules and reporting requirements This group tackled issues as complex as they come. They are devoted to ensuring we craft an accounting regime that will best serve the public interest. We all benefit from their contributions and hard work. I also wish to commend the leadership of our Chairman, FCC Commissioner Martin. Commissioner Martin has encouraged the Joint Conference to act expeditiously on the specific accounting rules before us and also to look more broadly at what needs to be done so that our accounting rules are up to the needs and the high standards of corporate governance that the American people have a right to expect in light of events over the past few years.